

IN THE QUEST TO CREATE SHAREHOLDERS' WEALTH

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Abstrak:

Dengan semakin ketatnya persaingan bisnis, perusahaan-perusahaan dituntut untuk menjadi semakin efisien agar setidaknya dapat mempertahankan kelangsungan hidupnya, lebih baik lagi jika perusahaan-perusahaan tersebut dapat menjadi yang terbaik di industrinya masing-masing. Oleh karenanya, setiap perusahaan berusaha mencari alat, standar atau bechmark yang sesuai dengan kondisi perusahaannya dan kemudian menerapkannya di semua bidang, termasuk keuangan. Salah satu alat bantu di bidang keuangan yang sedang hangat dibicarakan adalah Economic Value Added (EVA), yang menjadi pokok bahasan artikel di bawah ini.

Introduction

There is a belief, especially in capitalist countries, that the fundamental goal of all businesses is to maximize shareholder value. Failure to do so may result in pressure from the board of directors, activist shareholders, or even a hostile takeover. However, in countries such as Japan and in Europe more weights are given to the interests of customers, suppliers, workers, the government, debt providers, equity holders and even society at large. They believe that maximizing shareholder value is shortsighted, inefficient, simplistic and antisocial. They prove their point of view with the high standard of living and rapid economic growth in Europe and Japan, and to the success of Japanese auto and consumer electronics companies.

On the contrary, a US-style system based on maximizing shareholder value, accompanied by broad ownership of debt and equity and an open market for corporate control, appears to be closely linked with: a higher standard of living, greater overall productivity and competitiveness, and a better functioning equity market. It leads to the fact that shareholder wealth creation does not come at the expense of other stakeholders. Winning companies, when compared to their competitors, have greater productivity, greater increases in shareholder's wealth, and higher employment, which create relatively greater value for customers, suppliers of capital, labor, and the government (via taxes paid).

As capital markets continue to globalize, capital becomes ever more mobile. Thus, if countries whose economic systems are not based on maximizing shareholder value give investors lower returns on capital than those who do, sooner or later they will be left and be starved for capital. Then the next question will be; what is the best measure to assess the value of all companies?

In general, there are two major valuation approaches that compete with each other:

1. In the *accounting approach*, all that matters are the accounting earnings of the firm. Value is simply earnings times some multiple (the price-earnings or P/E ratio).
2. In the *discounted cash flow approach*, the value of a firm is the future expected cash flow discounted at a rate that reflects the riskiness of the cash flow.

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Accounting Approach

In practice, for years Earning Per Share (EPS) has been used as the most reliable information in revealing firms' performance. User ranges from the insiders, i.e. all kinds of managers who depend their annual bonuses on this measurement, to outsiders, such as investors, analysts, and money managers who wants to maximize their investment. In addition to EPS, they also use other measurements such as sales growth, market share, earnings, return on equity, free cash flow, operating margin, return on assets, plant utilization, etc., which often create conflicting objectives and ambiguous performance. For example, when top managers emphasizes on the firm's growth on market share, they care less on the cost to build it, which may reduce the value of the firm itself. Moreover, although useful, these measures can mislead. For instance, a highly leveraged company can post an inflated ROE. Accounting policies and earnings management can distort EPS. Positive ROA can hide return below the cost of capital.

Accounting earnings rarely reflects the value of a firm since earnings per share or return on equity are usually used in a myopic way – requiring information about only the next few years at best. Furthermore, earnings tends to focus mainly on managing the income statement and places low weight on the actual amount and timing of cash flows. Even the spread between the return on invested capital (ROIC) and the cost of capital can be a bad metric if used only for the short term and because it encourages underinvestment (harvesting the business to increase ROIC). These performance measures are not comprehensive and are not well correlated with the actual market value of companies.

Therefore, accounting earnings is useful for valuation only when earnings is a good proxy for the expected long term cash flow of the firm. Not all firms generate the same cash flow for each rupiah of earnings, however, so earnings approaches are generally only useful for very rough value approximation.

Discounted Cash Flow Approach (DCF approach)

In this approach, the value of a firm equals the present value of its expected cash flows discounted at an appropriate discount rate. DCF approach is better than accounting approach because it is the only measure that requires complete information. To understand value creation one must use a long term point of view, manage all cash flow on both the income statement and the balance sheet, and understand how to compare cash flow from different time periods on a risk-adjusted basis. However, many practitioners become confused in defining the cash flow or determining the proper discount rate.

Among many different DCF approaches, there are two outstanding approaches that they are straightforward to use and they provide insights into the underlying economics of the firm being valued. They are the entity DCF model and the economic profit model.

Entity DCF model

The entity DCF model values the equity of a company as the value of a company's operations (the entity value that is available to all investors) less the value of debt and other investor claims that are superior to common equity (such as preferred stock). This model is especially useful when extended to a multibusiness firm. The equity value of the corporate equals the sum of the values of the individual operating units, plus cash-generating corporate assets, less the cost of operating the corporate center and the value of the corporate's debt and preferred stock.

Economic profit model

In the economic profit model, the value of a firm equals the amount of capital invested plus a premium equal to the present value of the value created each year going forward. An advantage of the economic profit model over the entity DCF model is that economic profit is a useful measure for understanding a firm's performance in any single year, while free cash flow is not. It because free cash flow in any year is determined by highly discretionary investments in fixed assets and working capital. Therefore, management could easily delay investments simply to improve free cash flow in a given year at the expense of long-term value creation. Economic profit is also called residual income or Economic Value Added (EVA®), which is a trademark of Stern Stewart & Co. In order to avoid any confusion between these terms and for convenience, EVA will be used hereafter.

Although FORTUNE magazine called the EVA as "today's hottest financial idea and getting hotter" while Stern Stewart & Co. popularize it in its consulting practice, the concept itself dates back to the economist Alfred Marshall who wrote in 1890: "What remains of his (the owner or manager's) profits after deducting interest on his capital at the current rate may be called his earnings of undertaking or management." It means that the value created by a firm during any time period must take into account not only the expenses recorded in its accounting records but also the opportunity cost of the capital employed in the business.

Shareholder Wealth

Firms compete with each other to become the winning firm by implementing many management tools. However, since most of them do not have an integrated system of corporate management, most of the time those objectives become ambiguous and conflicted with each other. For instance, a firm may use discounted cash flow for capital budgeting; earnings for setting goals, communication with investors, and performance measurement; and budgets for bonuses. As predicted in the classic study of Berle and Means, the most destructive result from this conflict is that top managers as the trusted agents of the owner of the firms, neglect their main duty to maximize the shareholder wealth, and may be more interested in their personal welfare, such as their ever increased bonus and salary.

On the contrary, basic corporate finance and microeconomic theory tells us that the prime financial directive of any firm ought to be to maximize the wealth of its shareholders. This objective also serves as a rule in managing and allocating scarce resource efficiently, which in turn benefit society at large.

However, maximizing the shareholders' wealth is not the same as maximizing the firm's total market value. A firm's total value could be maximized simply by investing as much capital in it as possible. On the contrary, shareholders' wealth can only be maximized by maximizing the difference between the firm's market capitalization and the total capital that investors have committed to it. The difference is called Market Value Added (MVA):

$$\text{MVA} = \text{Market Capitalization} - \text{Invested Capital}$$

where market capitalization is the market value of equity and debt.
invested capital is a firm's total book debt and book equity capital base including retained earnings and equity-equivalent reserves, such as capitalized R&D expenses.

MVA reflects market's belief of the firm's future returns either above or below its cost of capital. The MVA concept implicitly assumes the stock market's efficiency as a discounting mechanism.

The next question will be; what kind of measure that best represent this MVA? Based on the research of Stern Stewart & Co. for firms included in *Stern Stewart Performance 1000*, the changes in these firms' EVAs over a five-year period account for nearly 50% of the changes in their MVAs recorded over that same time. By comparison, growth in sales explained 10% of the MVA changes, growth in earnings per share just 15% to 20%, and return on equity only 35%. Thus, EVA is the best. The reason why EVA is not more than 50% is simply because stock prices are forward-looking, thus creating a fundamental mismatch between the time perspective of EVA and MVA. It means that a firm's stock price at any point in time is half-determined by the EVA over the first five years and half-determined by the expected EVA for all future years after that.

Economic Value Added (EVA)

Arithmetically EVA equals the after-tax operating profits minus the appropriate capital charge for both debt and equity (usually it is approximated using weighted average cost of capital – WACC). What remains is the dollar amount by which profits in any given period exceed or fall short of the cost of all capital used to produce those profits. This issue is the greatest difference between EVA and other financial measurement, since almost all other financial measurements only look at the earnings reported in the accounting or financial statements, which often mislead. What looks like a profit in the accounting report may be a loss since it has not counted the cost to the shareholders yet. As Peter Drucker put it in his 1995 Harvard Business Review article: "EVA is based on something we have known for a long time: What we call profits, the money left to service equity, is usually not profit at all. Until a business returns a profit that is greater than its cost of capital, it operates at a loss. Never mind that it pays taxes as if it had a genuine profit. The enterprise still returns less to the economy than it devours in resources... Until then it does not create wealth; it destroys it." Hence, true profits do not begin until the cost of capital, like all other costs, has been covered. Thus, the formula for EVA is:

$$\text{EVA} = \text{NOPAT} - \text{C\%}(\text{TC})$$

where NOPAT is net operating profit after taxes

C% is the percentage cost of capital, which is usually approximated using the weighted average cost of capital (WACC)

TC is total capital.

From the above formula decision-makers should know that there are three ways to increase EVA. First, they may increase the efficiency of the firm either resulting in increasing NOPAT without using more capital or decrease total capital. Second, they may use less capital (i.e. decreasing the cost of capital and TC). Third, they may invest capital in high-return projects (i.e. well above the firm's cost of capital) or withdraw from projects giving returns below the cost of capital.

To put it more simply, EVA is an estimate, however simple or precise, of a business's true economic profit. EVA thus differs from accounting profit.

1. EVA is the residual income remaining after subtracting the cost of all the capital that has been employed to produce the operating profit. It thus integrates operating efficiency and balance sheet management in one measure accessible to operating people.
2. EVA is charged for capital at a rate that compensates investors for bearing the firm's explicit business risk.
3. EVA adjusts reported accounting results to eliminate distortions encountered in measuring true economic performance.

As mentioned above, EVA can be simple or precise, depending on how many adjustments a firm is willing to make. Presently, Stern Stewart & Co. has identified 164 adjustment issues, however, in adding one more adjustment each firm should consider the cost and benefit of more precise measure it gives. In general, a firm only uses five to ten adjustments depending on its nature of business.

Overall, EVA is a financial management system, i.e. the set of financial policies and procedures, and measures and methods, which guide and control a firm's operations and strategy. The financial management system concerns such things as setting and communicating financial goals, both internally and externally; evaluating both short-term profit plans and long-term strategic plans; allocating resources, from deciding where to buy a new piece of equipment to acquiring and divesting entire companies; evaluating operating performance from a financial perspective and tracing the sources of that performance back to the strategic and operating levers available to managers. Therefore, the term EVA has come to be used as shorthand for any system of corporate management that defines profitability in terms of return on capital and aims specifically at boosting the return above the cost of capital.

EVA and Incentive Compensation System

Since EVA is used as the centerpiece of a completely integrated framework for financial management that are anchored by the incentive compensation plan, the efficacy of EVA can not be reached if the firm itself does not integrate it with firm's compensation system. Integrating EVA with the firm's compensation system will result in changing behavior throughout the firm. On the contrary, if all a firm intends to do is measure EVA and use it as one more benchmark of performance, it probably is not worth the bother, because it will only be an interesting information, no more and no less.

There is no doubt that all of the managers have an intense desire to succeed and somehow they have the capability to succeed. Therefore, the central question faced by all top managers and board of directors is how to develop and direct those managers in ways that maximize the success of both the individual and the enterprise. The answer lies in human nature: people do what you reward them for doing, not what you exhort them to do. The secondary goals and incentives sent down by the executives may get some attention, but a manager or worker's real energy will be focused on the variable that drives his or her bonus or is most likely to lead to a promotion. Thus, if the executives pay people for generating more EVA, they will get more EVA and, with it, a higher share price and greater shareholder wealth. In addition there will be a more successful organization that provides greater non-monetary satisfaction as well.

In order to achieve this objective, more and more firms use EVA because EVA differs in two ways from the conventional incentive compensation system recommended by consulting firms. First, EVA bonus plan does not have any caps, the more EVA increases, the bigger the bonus-without limits. It can be offered because the firm pays only for sustainable increases in EVA, and a portion of any exceptional bonus award goes into a "bonus bank" for payment in future years, and is forfeited if EVA subsequently falls. It is quite

common in practice that when bonus plans are based on improvements in EVA as opposed to absolute EVA, the firm typically holds hostage as much as two thirds of declared bonuses tied to EVA. And managers will lose this two thirds if they do not at least maintain the level of performance that caused the declaration of the bonus in the first place. The consequence of this bonus bank feature is to lengthen the managerial decision-making horizon beyond one year. For a successful manager under this plan, each new year brings steadily increasing payouts, new declarations, and new hold-backs. Under this system, a manager receives around 90% of his bonus within six years. The most significant result of this "uncap bonus" is that it gives managers a pecuniary reason to continue striving for better and better performance even in boom years. In addition, the "bonus bank" guards against the temptation to game the system by sacrificing the future for short-term gain. These two features in the end shape the managers to act like an owner.

Secondly, the targets for EVA improvement under the bonus plan are automatically reset by formula instead of negotiating a budgeted level of improvement each year. Hence, managers under an EVA bonus plan are encouraged to propose aggressive budgets because they will not be penalized for falling short. On the other hand, they will get paid extra for everything they do achieve.

EVA and Long Term Perspective of the Firm

One of EVA's major advantages differentiating it significantly from other financial measures is that EVA has a long-term perspective view. It is not only analyzed a firm's historical performance but in order to assess the real value of the firm it needs to forecast the future value of that firm. Time must be considered because the firm's key value drivers, growth and return on invested capital, are not constant overtime.

Doing so, firms must evaluate their strategic position, considering both the industry characteristics and their competitive advantages or disadvantages. This will help firms assess their growth potential and their ability to earn returns above their cost of capital.

Competitive advantages that translate into a positive spread of ROIC and WACC can be categorized into three types:

- Providing superior value to the customer through a combination of price and product attributes that can not be replicated by competitors.
- Achieving lower costs than competitors.
- Utilizing capital more productively than competitors.

Identifying firm's competitive advantage, one may use customer segmentation analysis, competitive business system analysis, and industry structure analysis.

Once the firm knows its competitive advantage and how to achieve and sustain it, it should develop performance scenarios. Doing this, the firm is aware that forecasting financial performance is at best an educated guess. The best the firm can do is narrow down the range of likely future performance.

Summary

Among so many financial measures and corporate standards and benchmarks, recently EVA stands out from the crowd. More and more well known best companies in their own industries, as diverse as AT&T, Coca Cola, Siemens, and Merrill Lynch implement it in their system. Even business magazine such as Fortune called it as "today's hottest financial idea and getting hotter". Although basically EVA is a financial measure of corporate performance, the features it has differentiate it with others significantly. Its main difference with others is that it charges profit for the cost of all the capital a firm employs. The capital charge in EVA is what economists call an opportunity cost.

Additionally, EVA helps managers to pay attention on the long-term perspective of the firm. Hence, EVA is not only useful in the financial aspect of the firm, it has broader view that it incorporate firm's strategic planning as well in order to see how firms can strive to be the best it can be. However, to succeed EVA should be integrated with the firm's compensation system.

As the result, EVA gives managers superior information and superior motivation to make decisions that will create the greatest shareholder wealth in any publicly owned or private enterprise.

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